BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

Tn the Matter of the Appeal of	)
	)
DALE H. AND SUZANNE DeMOTT	)

For Appellants:	Dale H. DeMott, in pro. per.
For Respondent:	Crawford H. Thomas Chief Counsel
	Karl F. Munz Counsel

OPINION

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Dale H. and Suzanne DeMott against proposed assessments of additional personal income tax in the

amounts of $322.42, $396.25, and $470.27 for the years 1966, 1967, and 1968, respectively. Dale H. DeMott will hereinafter be referred to as appellant.

The primary issue is whether royalty payments, received by an inventor as consideration for transferring all substantial patent rights in certain inventions to a corporation wholly owned by him, qualify for capital gains treatment.

In 1965 appellant transferred certain assets to the DeMott Electronics Company. The transaction was described as follows on appellant's personal income tax returns for the years in question:

> Sale of inventions -- On April 30, 1965, Dale H. DeMott, inventor of patented or patentable devices described as servo-controllers, AC and DC power supplies, amplifiers, analyzers, etc., sold to DeMott Electronics, a California Corporation, various drawings, sketches, prints, working models, etc., together with all substantial rights to manufacture and sell the articles.

In return, appellant was apparently to receive royalties equal to 5 percent of the corporation's gross sales per year for a five year period.

At the time of the transfer, appellant was the sole shareholder of DeMott Electronics. He alleges that he had an agreement at that time to sell a "controlling interest" in the corporation to a person or persons unnamed. Respondent has conducted an audit of the corporation's tax returns, however, which reveals that as late as March 1969 appellant still owned all the corporation's outstanding stock.

Appellant reported the royalty payments, as capital gain on his state and federal personal income tax returns for the years in question.. Respondent determined, however, that the payments were ordinary income. It accordingly issued the proposed assessments in question.

Revenue and Taxation Code section 18192, as it read during the appeal years, provided in relevant part:

> A transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent. .. by any holder shall be considered the sale or exchange of a capital asset held for more than six months, ...

This provision is limited by section 18195, which states:

> Section 18192 shall not apply to any transfer, directly or indirectly, between persons specified within any one of the paragraphs of Section 17288; except that, in applying Sections 17288 and 17289 for purposes of Sections 18192 through 18 195 --
>
> (a) The phrase "25 percent or more" shall be substituted for the phrase "more than 50 percent" each place it appears in Section 17288,. ..

Subdivision (b) of section 17288 refers to:

> An individual and a corporation more than SO percent in value of the outstanding stock of which is owned, directly or indirectly, by or for sudh individual,. ..

Respondent concedes that the items which appellant transferred to DeMott Electronics should be treated as "property consisting of all substantial rights to a patent" for purposes of section 18192. Respondent further concedes that appellant qualifies as a "holder. " (See Rev. & Tax. Code, § 18193.) It argues, nevertheless, that section 18192 does not apply under the facts of this case, because of the limitation contained in section 18195.

We agree with respondent. Sections 18195 and 17288, read in conjunction, provide that section 18192 shall not apply to a transfer to a corporation if the transferor owns 25 percent or

more in value of the corporation's outstanding stock. At the time of the transfer in question, appellant owned 100 percent of DeMott Electronics' stock. Although he alleges that he had an agreement to sell. a "controlling interest" in the corporation, he does not contend that he was committed to sell more than 75 percent in value of the stock. In fact appellant was still the corporation's only shareholder as late as March 1969, almost four years after the transfer of the patent rights. Under these circumstances, we must, conclude that the transfer does not qualify for capital gains treatment under section 18192.

The conclusion that section 18192 is inapplicable does not necessarily end our inquiry. Section 18 192 is substantially identical to section 1235(a) of the Internal Revenue Code of 1954. At the federal level, it is still an open question whether section 1235(a) is the exclusive means by which a holder's transfer of his patent rights may qualify for capital gains treatment. (Compare Myron C. Poole, 46 T. C. 392, with Treas. Reg. ,§ 1.1235-1(b) and Rev. Rul. 69-482, 1969-2 Cum. Bull. 164; see also, Ray E. Omholt, 60 T. C. 541; Cal. Admin. Code, tit. 18, reg. 18192-181.95(a), subd. (2).) We need not resolve this question here, however, since there is nothing in the record to indicate that the transfer in question would be eligible for capital gains treatment under any other provision of the law. Appellant has the burden of proving facts which entitle him to the benefits of the capital gain provisions (United States v. Wernentin, 354 F. 2d 757, 762), and since appellant has not met this burden, we must conclude that respondent properly treated the royalty payments in question as ordinary income.

Appellant also contends that he is entitled to deductions for depreciation of the items transferred to DeMott Electronics, and also for bad debt deductions for loans allegedly made to the corporation. Appellant has failed to establish, however, that he had a depreciable interest in the transferred property. (See Ernest L. Rink, 51 T. C. 746.) Nor is there any evidence of loans to the corporation, or any indication that the alleged debts ever became worthless. (See Appeal of Andrew J. and Frances Rands, Cal. St. Bd. of Equal. , Nov. 6, 1967.) Accordingly, we cannot accept appellant's contentions.

For the above reasons, we sustain respondent's action.

O R D E R

Pursuant to the views expressed in the opinion of the boakd on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Dale H. and Suzanne DeMott against proposed assessments of additional personal income tax in the amounts of $322.42, $396.25, and $470.27 for the years 1966, 1967, and 1968, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 5th day of April, 1976, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____. Member

_____, Member

ATTEST-: _____, Executive Secretary